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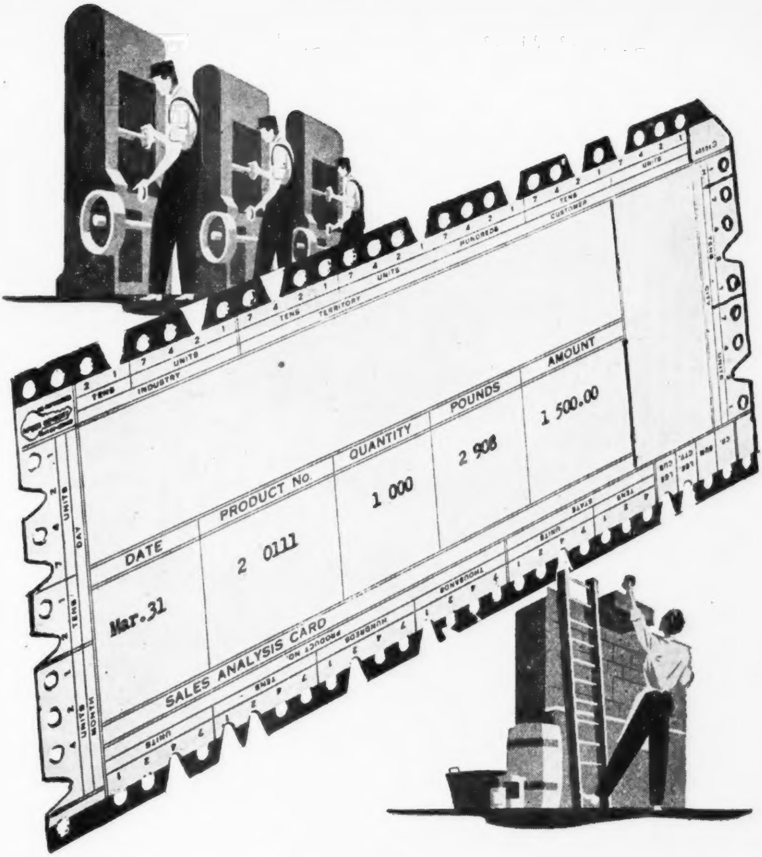

SALES ANALYSIS CARD
DATE
PRODUCT No.
QUANTITY
POUNDS
AMOUNT
Mar. 31
2 0111
1 000
2 908
1 500.00
INDUSTRY
TERRITORY
CUSTOMER

Why one husband kissed his wife four times!

"Here's a kiss for the money you're saving...while it's coming in faster through the war years. I know in my bones jobs like mine may not last forever. Who can tell what's going to happen day-after-tomorrow? Thank God you've got sense enough to see that to-day's the time to get a little money tucked away.

"Here's a kiss for the War Bonds you're making me hold on to! I'd never do it without you, honey, it's too easy to find reasons for cashing 'em in—but when it comes time to put the children through school or pay for an emergency operation, we'll be thankful.

"Here's a kiss for the insurance you talked me into buying. I've felt a lot easier ever since I've known our future is protected—you and the kids would be safe if anything happened to me—you and I won't have to spend our old age living on someone's charity. And every cent we put in insurance or War Bonds or other savings helps keep prices down.

and

here's a kiss for being *you*—a woman with brains enough in your pretty head to make sure we don't buy a single thing we *don't* need in times like these—because you know a crazy wave of spending in wartime would march America straight into inflation. Baby, I sure knew how to pick 'em the day I married you.

ONE PERSON CAN START IT!
You give inflation a boost

- when you buy anything you can do without
- when you buy above ceiling or without giving up stamps (Black Market!)
- when you ask more money for your services or the goods you sell.

Save your money. Buy and hold all the War Bonds you can afford—to pay for the war and protect your own future. Keep up your insurance.

HELP US KEEP PRICES DOWN

A United States War message prepared by the War Advertising Council; approved by the Office of War Information; and contributed by this magazine in cooperation with the Magazine Publishers of America.

Announcing a

PRIZE ESSAY CONTEST

The Committee on Publications announces a prize essay contest, the essays, to be submitted by December 15, 1945, to be on a subject of interest to the accounting profession and suitable for publication in The New York Certified Public Accountant. Prizes in the amount of $150 for first prize, $100 for second prize, and $50 for third prize are offered.

The general rules of the contest are as follows:

All papers shall be original and the manuscript shall be typed in duplicate on 8½ x 11 stationery, double or triple space typing, and should not be more than 5000 words.

★

The name of the individual submitting the paper should not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address.

★

When submitted to the judges, each manuscript will be given a key number of identification.

★

Manuscripts should be forwarded to The Managing Editor of The York Certified Public Accountant, 15 East 41st Street, New York 17, N. Y., on or before December 15, 1945. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in The New York Certified Public Accountant. The decision of the judges shall be final as to what papers may be entitled to prizes.

It is suggested that contestants read the comments on previous contests by Hugh O'Reilly appearing on page 452 of the August 1945 issue of The New York Certified Public Accountant.

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

The matter contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XV *September • 1945* NO. 9

Contemporary Accounting—New York State Taxes

By BENJAMIN HARROW, C.P.A.

This article has been prepared as a supplement to "Contemporary Accounting", which has been prepared by the American Institute of Accountants. A reprint of this article is available at the Society's office for fifteen cents.

A. The New New York State Franchise Tax on Business Corporations

IN 1944, Article 9-A of the New York State Tax law dealing with the Franchise Tax on Business Corporations was entirely rewritten (Chapter 415 of the laws of 1944).

Taxable under the new Article 9-A are not only ordinary business corporations taxed under the old Article 9-A but in addition "holding corporations" (formerly taxed under section 188, Article 9) and "investment trusts" (formerly taxed under section 214-b, old Article 9-A). However, the income and capital of every taxable corporation is treated differently according to whether it is (a) "business income" and "business capital", (b) "investment income" and "investment capital", (c) "subsidiary capital" and the income derived therefrom.

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As under the old law, the tax on business corporations is not an income tax as such but a franchise or privilege tax, levied—even when no income has been realized — on domestic corporations for the privilege of exercising the corporation franchise, and on foreign corporations for the privilege of doing business in the state (sec. 209-1). Ordinarily the income of the corporation is the most important factor in determining the amount of the tax.

Entities Subject to the Tax

The term "corporation" includes any entity created as such under the laws of the United States, any state or any foreign country; joint stock companies or associations; any business conducted by a trustee, wherein interest is evidenced by certificates; dissolved corporations which continue to conduct business. The term "corporation" does not include membership or other non-stock corporations, unless they are doing business for profit (Reg. Art. 120).

A domestic corporation is taxable as long as it has legal existence, and after its dissolution if it continues to do business. The liquidation of its assets and distributions of the proceeds is not considered as doing business. A foreign corporation is subject to the tax if it does business in New York, irrespective of whether it has qualified formally to do so. (Reg. Art. 140). The law (sec. 209-4) and the Regulations (Art. 141) enumerate a number of factors which determine the question of whether a foreign corporation is doing business in New York. The maintenance of cash balances with banks or trust companies in New York and the keeping of stocks or securities in New York are not factors to be considered in deciding this question.

In addition to the already mentioned non-stock corporations organized and operated exclusively for non-profit purposes, the following corporations, subject to special franchise taxes are exempt from the Franchise Tax on Business Corporations: Real estate corporations, public utilities, certain agricultural corporation, banks, trust companies and insurance companies. Also exempt are savings banks, foreign corporations engaged wholly in interstate commerce and domestic ship-owning corporations, all of whose vessels are employed between foreign ports and ports in the United States.

Tax Periods

An important change has been introduced by the new law in *making the basic year and the privilege year identical.* Under the old law the privilege period was the year beginning November 1, while the tax was measured by the income or employed capital during the basic year, that is the calendar or fiscal year ending not later than the June 30 preceding the beginning of the privilege year. Under the new law, the calendar or fiscal year, on which the corporation keeps its accounts is both its privilege and basic year. As the liability of the corporation to pay the franchise tax for the exercise of its franchise is now determined on the first day of its fiscal or calendar year, the U. S. Treasury department has held that the Franchise Tax accrues, for the purpose of deductibility for federal income tax purposes on the first day of the corporation's taxable year, although the amount of the tax cannot be determined before the close of its taxable year.

The transition from the old to the new current method had to accomplish two purposes: firstly, to bring the basic period up to the privilege period; secondly, to include all basic periods not yet used by the taxpayers. This was effected by declaring the period from November 1, 1944 to the end of the corporation's current calendar or fiscal year as the privilege period of all unused basic periods, until the privilege period coincided with the basic period. In the case of calendar year corporations, this occurred in the year 1945, which will be reported as both a basic and privilege year in May 1946. The consequence of the transition provision is, that on November 1, 1944, two, and in the case of certain fiscal year corporations, sometimes three franchise taxes accrued, and were deductible

on the Federal return for periods including November 1, 1944.

Similar transition provisions were established for holding companies, formerly taxed under the old Sec. 188, in the case of which the privilege period was the calendar year following the base period.

Corporations which cease to exercise their franchise or to do business, before all of their income has been used as a basis for any franchise tax, have to pay the tax on the income not yet so used.

Bases and Rates of Tax

The new tax consists of two parts: (1) the greatest amount resulting from one of the following computations: (a) 6% of the entire net income, as defined by the law and allocated to New York. (b) one mill for each dollar of the business and investment capital allocated to New York. (c) 6% of 30% of the net income plus officers' salaries and compensation paid to stock-holders owning more than five percent of the issued stock, minus $5,000. and any net loss for the reported year, using the allocation percentage provided for the allocation of the entire net income. (d) $25. (2) a tax computed on the subsidiary capital allocated to New York amounting to ½ mill on the first $50,000,000., ¼ mill on the next $50,000,000. and ⅛ mill on the excess over $100,000,000. All computations as to bases, allocation and rates have to be made by the taxpayer on forms 3CT and 3CT-1, except the computation stated under (1) (c) above, which will be made by the Tax Commission on the basis of the information provided for on the form.

The terms "entire net income", "business and investment capital", and "subsidiary capital" will be considered first: the discussion of the principles of allocation will follow.

Elements of Income

"*Entire net income*" means total net income from all sources, which shall be presumably the same as the entire net income which the taxpayer is required to report to the United States Treasury Department (sec. 208) with the following exceptions:

The Federal net income is to be decreased by: (1) interest, dividends and capital gains from subsidiary capital (that is investment in stock of and indebtedness from a corporation, over 50% of whose voting stock is owned by the taxpayer); (2) 50% of all other dividends.

The Federal net income is to be increased by: (1) Interest on Federal, State, Municipal and other obligations, which are exempt under Federal law; (2) Net operating losses sustained during any other year or period; (3) Interest on indebtedness to stock-holders (or members of their families) owning more than 5% of the issued capital stock, less 10% thereof or $1,000., whichever is larger; (4) Expenses attributable to producing subsidiary income or capital gains or losses.

Federal taxes measured by profits or income are not deductible. The franchise tax itself is deductible only insofar as it is based on a period immediately preceding the period covered by the report (Sec. 208).

When use is made of allocation, or the corporation has subsidiary capital, "entire net income" is to be shown in two parts, namely, "*investment income*" and "*business income*". Investment income means income, including capital gains in excess of capital losses from investment capital, as defined below, less allowable deductions attributable in the discretion of the Tax Commission to investment income. It includes 50% of dividends from non-subsidiary stock held for investment, interest from non-subsidiary securities held for investment, interest from subsidiary securities claimed by subsidiaries as

a New York Franchise tax deduction, interest on bank accounts elected to be treated as investment capital, net capital gains from sales and exchanges of non-subsidiary stocks and securities held for investment. The difference between "entire net income" and "investment income" is "business income". It includes all income including net capital gains, except income from subsidiary capital and investment income, less allowable deductions not attributable to investment income.

Elements of Capital

The term *"business capital"* means the total average fair market value of all the taxpayer's assets, excluding the assets constituting investment capital or subsidiary capital, less current liabilities payable on demand or within one year from the date incurred, to the extent such liabilities are not deducted in computing subsidiary capital.

Loans to a subsidiary, the interest on which is claimed by and allowed to the subsidiary as a deduction, are business capital, if such loans are not evidenced by bonds or other securities. Such loans are investment capital, if evidenced by a bond or other security. If no deduction for interest is claimed by the subsidiary, the loans are subsidiary capital.

Although the tax on *"investment capital"* is the same as on business capital (one mill), it is to be set up and reported separately, whenever use is made of allocation, or the Corporation has subsidiary capital. The term "investment capital" means the total average fair market value of the taxpayer's investments in stocks, bonds and other securities, issued by any corporation, other than a subsidiary, or by a public authority, with the exception of securities held by the taxpayer for sale to customers in the regular course of business.

"Subsidiary capital" means investments in the stock of subsidiaries and any indebtedness from subsidiaries, "provided however, that, in the discretion of the Tax Commission, there shall be deducted from subsidiary capital any liabilities payable—on demand—or within one year—which are attributable to subsidiary capital" (sec. 208-4). As has been stated above, a "subsidiary" is a corporation over fifty percent of whose voting stock is owned by the corporation.

Special rules are established for *cash and U. S. Government obligations.* If the subsidiary capital is more than 85% of the total capital (computed without cash and U. S. Government obligations), that is, if the corporation is actually a holding company, it may elect to treat its cash and U. S. Government obligations in part as subsidiary capital, up to the proportion that its subsidiary capital bears to its total capital. The balance of the cash, and in cases where subsidiary capital is less than 85%, all cash may be included either in investment capital or in business capital, at the election of the taxpayer. U. S. Government obligations not included according to the method stated as subsidiary capital, are investment capital, unless held for sale to customers, in the regular course of business, in which case they are includible as business capital (Reg. Art. 352).

In determining *"average fair market value"* allowance is to be made for variations in the amount of assets as well as variations in market prices. (Reg. Art. 335). The average is usually to be computed on a quarterly basis but the taxpayer may elect to use a more frequent basis, and if the result is not distorted even a semi-annual or annual computation is permissible (Reg. Art. 335-10).

Allocation of Income and Capital

The total income and capital of a corporation is not the basis for its Franchise Tax, but only the part *allocated to New York State.* Every corporation has the right to allocate its investment income and capital, and its subsidiary capital. Business income and capital may be allocated only if the corporation has a regular place of business outside the state (Sec. 210). Corporations which are not entitled to allocation, and which have no subsidiary capital, prepare their reports on the principal form 3CT; the others must fill out in addition the supplemental form 3CT-1.

Three allocation percentages must be computed: a business allocation percentage, which is applied to business income and to business capital; an investment allocation percentage, applied to investment income and investment capital; and a subsidiary allocation percentage, applied to subsidiary capital. The sum of the allocated parts of business and investment income is the basis of the 6% tax. The sum of the allocated parts of business and investment capital is subject to the one mill tax, which takes the place of the tax on income, if the amount is greater; and the subsidiary capital tax ranging from ½ to ⅛ mill is computed on the allocated part of the subsidiary capital.

For the *allocation of business income and business capital,* the so-called Massachusetts formula is now used. The percentages which (a) the real and tangible personal property, (b) the business receipts and (c) the payrolls within New York are of the total real and tangible personal property, total business receipts and total payrolls are added; the sum of the percentages divided by three (or by two if there are only two percentages) constitutes the business allocation percentage. The property is to be evaluated at average fair market value. The business receipts allocable to New York include receipts from sales of tangible personal property located in New York State at the time of receipt of or appropriation to the orders; from sales of tangible personal property not located, at time of receipt of or appropriation to the orders, at any permanent place of business outside New York State, if the orders were received or accepted in New York State; from services performed in New York State; from rentals of property situated in New York State; from royalties for the use in New York State of patents and copyrights; all other business receipts earned in New York State. Payroll includes wages, salaries and other compensation of employees, except general executive officers. Employees within New York means all employees regularly connected with or working out of an office or place of business maintained by the taxpayer within New York.

The *investment income and investment capital allocation* percentage is determined as follows: the taxpayer's average holding of stocks, bonds or other securities of each other corporation, other than its subsidiaries is multiplied by the percentage of the capital allocation established for each such issuing corporation on its preceding Franchise Tax report. The amounts so obtained are added. To this is added capital invested in bonds or other securities of the State of New York, its municipalities and instrumentalities. The result so obtained is divided by the total of the corporation's holdings of stocks, bonds and other securities, except obligations of the United States and its instrumentalities and except cash, if the election has been made to treat cash as business capital, in the manner stated above. The securities used in computing the investment allocation percentage are to be valued at average fair market value. If a security has been held

for only a part of the period covered by the report, the fraction which the holding period is of the report period is to be applied to the average fair market value of the security.

The investment allocation percentage so obtained is applied to investment income without any limit. As to investment capital, the part allocated to New York shall not be less than 15%, unless the taxpayer proves that less than 15% of its investment capital is employed and less than 15% of its investment activities are conducted within New York.

Where the investment allocation percentage is zero, interest on bank deposits and Federal obligations are treated as business income and allocated by the business allocation percentage.

The *subsidiary capital allocation percentage* is determined by the same method as used in the computation of the investment allocation percentage described above. The average fair market value of the investment in each subsidiary is multiplied by the allocation percentage used by the subsidiary corporation on its Franchise Tax for the preceding year. If cash and U. S. Government obligations are treated as subsidiary capital, they are multiplied by the weighted average of percentages used for all other subsidiaries. The amounts so obtained are added and the percentage of the sum to the total investment in subsidiaries constitutes the subsidiary capital allocation percentage, which is applied to subsidiary capital, that is, investment in subsidiaries less current liabilities attributable to subsidiary capital.

In the same manner as with investment capital, the subsidiary capital allocation percentage shall not be less than 15%, unless the taxpayer establishes to the satisfaction of the tax commission, that less than 15% of its subsidiary capital is employed and less than 15% of the subsidiaries' activities is conducted within the state.

On the other hand the law favors holding companies by providing that corporations, the subsidiary capital of which (including cash and U. S. Government obligations treated as subsidiary capital) is more than 85% of its total capital shall allocate not more than 50% of the subsidiary capital to New York.

The taxpayer is entitled to certain *Optional procedures* with regard to the use of allocation percentages (Sec. 210-6). If the investment income is less than 25% of the total business and investment income, the taxpayer may elect to apply its business allocation percentage to its entire net income and its total business and investment capital. If the investment income is more than 85% of the total business and investment income, the investment allocation percentage may be applied to entire net income and total business and investment capital. The includibility of cash and U. S. Government obligations in subsidiary capital, where this is more than 85% of the total capital has already been mentioned. All these optional procedures are not allowed in the case of a consolidated report.

If the allocation percentages are inequitable to the interest either of the taxpayer or the state, the tax commission may *adjust* them. (Sec. 210-8, Reg. Art. 415).

Reports and Payment of Taxes

All corporations subject to tax must file annual reports, irrespective of their income or capital; also every receiver, referee, trustee, consignee or other fiduciary or representative who conducts the business of any corporation. A foreign corporation, which has an officer, agent or representative within the state, must file a report (form 245CT) even if it is

not subject to the tax. A corporation ceasing to exercise its franchise or to do business in New York must file a report on the date of such cessation. A domestic corporation may not dissolve or consolidate with a foreign corporation without consent of the State Tax Commission (Reg. Art. 900).

A corporation may be permitted or required to report on a *consolidated basis*, if it owns or controls directly or indirectly substantially all the capital stock of one or more other corporations or if substantially all its capital stock is owned or controlled by one or more other corporations. "Substantially all" will generally mean 95% or more. (Sec. 211, Reg. Art. 560) Under consolidated reporting the consolidated entire net income and capital of all the corporations are treated as that of one corporation; intercorporate stockholdings and intercorporate indebtedness are eliminated (Reg. Art. 315, 354). Consolidated reports are to be filled on form 3ACT.

The *time for filing* is May 15, except for those corporations, whose fiscal years end in March, April, May or June. They must file their returns four months after the close of their fiscal years.

The tax is payable in two installments, one half, but not less than $25. at the time of filing the reports. The balance is due when required by notice of assessment, but not later than the following January 15.

The tax commission not only has wide discretionary powers, as stated above, with regard to allocation and determination of subsidiary capital and investment income, but it is also entitled to consider any other pertinent data besides those contained in the taxpayer's report. It may make an *estimate of the tax* due from the taxpayer (Sec. 212), after having "audited and stated the account". If the audit and statement of account have not been made within five years after the report has been filed, the tax shall be final as set forth on the report. Thus the New York State Franchise Tax is an assessed tax, and not self-assessed as the Federal Corporation Income Tax. Within five years the tax commission may reaudit and restate the account, and it may do so at any time, if it has reason to believe that the report was false or fraudulent. The taxpayer is required to notify the tax commission of any change in Federal net income within thirty days or on its next report, whereupon the tax commission may reaudit the tax, without changing the original allocation.

The taxpayer may file an *application for revision* within two years after the original assessment of the tax, or within one year from the date of any reassessment (Sec. 214). The taxpayer may ask for an informal hearing. If a settlement is not reached, a formal hearing is held, and the commission determines the tax finally. This determination is subject to judicial review (Sec. 214, 215).

B. Comparison of New York State and Federal Income Tax Laws

Basis of Differences in Federal and State Tax Laws

"THE State Income Tax Law is generally patterned on the Federal Income Tax Act. However, there are numerous points of difference where the State statute or the regulations issued under the statute by the State Tax Commission depart from the Federal law or Federal decisions based upon the Federal law.

Some of these differences are due to basic problems of jurisdiction to tax as in the case of non-residents. Some differences are due to varying interpretations of the law on the part

of State and Federal authorities and still other differences are due to the deliberate intention on the part of the legislature to depart from the Federal plan."[1] Differences between Federal and New York State laws keep increasing. In some respects as in the matter of credit for earned income or the deductibility of expenses paid or incurred for the production of income, differences have vanished.

Entities Subject to Tax—Differences

As to the *entities subject to tax,* individuals, estates and trusts are taxable on their income under both laws. New York State taxes their entire income if they are residents of the State; if they are non-residents, that part of their taxable income is subject to tax which they receive from property owned or from a business, trade, profession, or occupation carried on or followed within the State of New York.

Corporations are not subject to the New York State Income Tax Law although they may be taxed on income under the Franchise Tax Law.

Partnerships as such are not taxable, the same as under the Federal law. However, they are required to file returns showing the distributive shares of the partners and the latter are taxed as individuals. However, partnerships as well as individuals may be subject to the Unincorporated Business Tax based on their business income allocated to New York. For this tax a deduction may be taken for salaries to the individual or partners. In addition an exemption of $5,000 is allowed.

Requirements for Filing a Return

The difference between State and Federal law as to the requirements for *filing a return* corresponds to the difference in the personal exemptions under both laws. The State law still follows the provisions of the original Internal Revenue Code and requires a return if the gross income and capital gain (without deduction for capital losses) of an individual is $5,000 or over, or if the net income equals or exceeds (a) $1,000 in the case of an unmarried person or a person not living with wife or husband during the entire year; (b) $2,500 in the case of a married person living with wife or husband during the entire year; (c) The appportioned part of the personal exemption of a married person ($2,500) who was married and living with wife or husband during only part of the taxable year.

The Federal law, as amended by the Individual Income Tax Act of 1944, requires a return of every individual married or single whose gross income is $500 or over.

Estates and trusts are required to file a return under the New York State law if they have net income and capital gain of $1,000 or more. The Federal law requires a return if the gross income of an estate or trust is $100 or more, and in all cases when a beneficiary of the estate or trust is a non-resident alien.

The "Pay As You Go" principle is unknown to the State law so that there is no estimated tax to be declared. The recent legislature considered a bill introducing this principle in State taxation but it was not adopted.

The filing date for State returns differs by one month from the filing date for the Federal return. It is April 15th instead of March 15th for income reported on a calendar year basis, and three and a half months instead of two and a half months after the end of a fiscal year for returns filed on a fiscal year basis.

Both laws permit the filing of *joint returns* for husband and wife, the Federal law without restriction, the State

[1] Harrow & Sack N. Y. Income and Franchise Taxes, 1941.

law only if husband and wife are living together.

Basis of Tax—Differences

The basis of the tax under Federal law and under State law is the *net income* which is defined in both laws as gross income less allowable deductions. There are a number of differences in the concept of *gross income*. According to the State law, earnings of a minor from *personal services* are his own income only if the minor has been emancipated. (Reg. Art. 525). The Federal law now considers amounts received in respect of the services of a child as his income without restriction even though such amounts are not received by the child (I.R.C., Sec. 22(m) (1) and where such income exceeds $500 a return is required to be filed for the minor. The State law has no provision similar to that of Sec. 107 of the Internal Revenue Code which allows the taxpayer receiving at least 80% of the compensation for personal services covering a period of thirty-six calendar months or more to decrease his tax to an amount which would have been payable if the compensation had been received ratably in each of the years during which the services were rendered.

The State excludes from gross income all compensation received by members of the Armed Forces prior to July 1, 1946; the Federal law excludes compensation for active service up to $1,500 as well as all mustering-out payments.

Interest on U. S. Obligations

While the Federal law distinguishes between *Interest on U. S. Obligations* issued before March 1, 1941 and after this date, treating those issued before March 1, 1941 differently with respect to normal tax and surtax, the State law excludes from gross income all interest upon obligations of the United States or its possessions or securities issued under the Federal Farm Loan Act, Home Owners Loan Act, War Finance Corporation or Reconstruction Finance Corporation.

Interest on all *obligations of states* and their political subdivisions are exempt under the Federal law; the State law excludes only interest on obligations of New York State and its political subdivisions, taxing the interest on obligations of other states.

Stock Dividends

The taxability of stock dividends under Federal and State laws is determined by reference to different standards. Under State laws, the term *stock dividend* is limited to any issue of *new stock representing capitalized surplus and profits distributed to shareholders in proportion to their previous holdings.* Such dividend distributions are not subject to State tax. But, dividends paid in stock of the declaring corporation, such as treasury stock, would be taxable because that would be a distribution of previously issued, and not new stock. Under Federal law, however, the standard revolves around the concept of income. Therefore, if a stock dividend has the effect of increasing the beneficial or proportionate interest of the stockholder recipient in the declaring corporation, then such economic benefit would be recognized and taxed as income within the meaning of the Sixteenth Amendment to the Constitution.

Living Quarters and Meals

Under State law pensions of employees of the State of New York and political subdivisions are exempt from tax. If *living quarters or meals* are furnished to an employee their value is taxable to the employee under both laws; but the Federal law excludes this part of the compensation from gross income if the living quarters or meals are furnished for the convenience of the employer (Reg. 29.22(a)-3); the State law does not make this distinction (Art. 25).

Capital Gains

Under the Federal law capital gains to the extent recognized are a part of gross income, subject under certain conditions to an alternative tax. The State law expressly excludes capital gains from gross income but subjects the arithmetic net capital gain to a special tax at one-half the rates on ordinary income. The Federal law distinguishes between long-term and short-term capital gains and losses; the State law does not make this distinction. The definition of capital assets is approximately the same under both laws, except that obligations of the United States or a State issued on a discount basis with a maturity of one year or less are not considered capital assets under Federal law. Also the State law does not contain a provision similar to Sec. 117(j) of the Internal Revenue Code which treats the gain from the sale or exchange of depreciable business property held for more than six months as capital gain.

Basis for Determining Gain or Loss

The basis for determining gain or loss on the sale or exchange of property under both laws is generally the cost of the property. Under the Federal law fair market value on March 1, 1913, instead of cost may be the basis if the property was acquired prior to March 1, 1913. Under State law fair market value on January 1, 1919, instead of cost may be the basis if property was acquired prior to January 1, 1919. The rules for using the fair market value basis are slightly different under both laws. For computing gain the laws agree, cost or fair market value, whichever is higher, being the basis; for computing loss, cost or fair market value, whichever is lower, determines the basis under State law; under Federal law the basis is cost. Both laws, the State law expressly, the Federal law by implication, recognize no gain or loss where the amount realized falls between cost and fair market value.

Property Acquired by Inheritance

For property acquired by *inheritance*, devise or bequest, the basis is the fair market value at the date of death. Differences exist between both laws where appraisals have been made for estate tax purposes. The Federal law gives the executor an election to have the values determined as of the date one year after the decedent's death, and where this election has been used, these values so determined become the basis. Under State law the basis is the value appraised for State estate tax purposes, that is the value at the date of death, and where no appraisal for New York estate tax purposes has been made, the valuation of the State of domicile for death tax purposes, and lastly the valuation for Federal estate tax purposes determines the basis of the property.

Property Acquired by Gift

For property acquired by *gift* on or prior to December 31, 1927, under State law or prior to January 1, 1921, under Federal law, the basis is the fair market value at the date of acquisition; for property subsequently acquired, the basis is the same as that of the donor or last preceding owner not acquiring by gift; for computing loss, this basis or the fair market value at the time of gift, whichever is lower, is determinative under both laws.

Basis for Stock Rights

As to *stockrights* the Federal law distinguishes between the stock and rights according to their relative fair market values at the time of issuance of the rights. Under State law the receipt of a right does not constitute income. In determining gain or loss from the subsequent sale of rights,

the Federal and State laws permit the use of a basis for rights which represents an allocated part of the cost of the stock in respect of which the rights were received, provided such rights when received were tax free under Federal (and State) law. In addition, the State allows the taxpayer the option of reporting the proceeds from sale of rights as taxable gain if such rights are quoted on a recognized stock exchange.

Distributive Share of Partnerships—Non Residents

There are important differences with regard to the *distributive share of partnerships* resulting from the different treatment of income and allowable deductions concerning all taxpayers. The State partnership-information return (which is coupled with the unincorporated business tax return) will generally show figures different from those on the Federal partnership-information return and the gross income from partnerships will be different on the individual Federal and State income tax returns. The differences increase in the case of a non-resident reporting his distributive share of a New York partnership for if the partnership does business both within and without the state, he may report only his distributive share of the partnership income attributable to New York. The distributive shares of partnership capital gains and loss will differ under both laws according to the different treatment of capital gains and losses already referred to.

As the income tax returns of *estates and trusts* will reflect all differences arising from the different concepts of gross income and allowable deductions, the distributive shares of the beneficiaries will accordingly be different under both laws.

Decedent's Income in Year of Death

Income of a decedent for the last taxable year in which death occurs may be reported under State law either on the accrual basis (old Federal law) or on the basis employed by the decedent prior to death (current Federal law), if the taxable year began on or after January 1, 1943. If the decedent, prior to death, reported on a cash basis, the last return may be filed on the same basis provided the executor or legal representative elects such method, in which event income or capital gains accrued to the date of death and not reported would be taxable to the estate or person entitled to receive such income or capital gains.

Differences in Deductions

The most important differences arise from the provisions referring to *deductions and credits.*

Interest

The State law disallows the deduction of interest "paid or accrued in connection with the ownership of real or personal property, current income from which is not required to be included in gross income." Thus interest on indebtedness arising from the acquisition of U. S. obligations or of obligations of New York State and its political subdivisions is not deductible. Non-residents may deduct only interest paid or accrued in connection with income from sources within the State. The Federal law disallows the deduction of interest paid or accrued on indebtedness incurred to purchase or carry U. S. government obligations, the interest upon which is wholly exempt.

Deductions for Taxes—Federal

The State law allows the deduction of all *Federal taxes* except Federal income, estate and gift taxes. Deductible under State law are therefore Federal import duties, excise and stamp taxes which the Federal law allows as a deduction only when paid or incurred in trade or business or for

the production or collection of income.

Taxes—State

Under Federal law all *State and local taxes,* except local benefit taxes, are deductible. The State law does not allow the deduction of any State or local income, estate or gift taxes. It has been held that the unincorporated business tax is an income tax and hence this too is not deductible. (Froelich *v.* Graves (1940) 259 App. Div. 30). The recent legislature however has passed a bill permitting a deduction for income taxes paid to another State if the latter State allows such a deduction to New York residents.

Income, estate and gift taxes levied by a *foreign country* are not deductible on the State tax return. The Federal law gives the taxpayer an election to treat foreign income and excess profits taxes as a deduction, or with certain limitations, as a credit against taxes.

Deductions for Losses

Losses are deductible under both laws if they are incurred in trade or business, or in any transaction entered into for profit, or if they are casualty losses. The State law does not contain the provision of the Federal law disallowing losses from the sale or exchange of property between members of a family, partners, controlled corporations and trusts, nor the provision disallowing losses from wash sales of stock or securities. The net operating loss carry-back and carry-forward provisions of the Federal law are unknown in the State law.

As stated above, capital gains do not constitute a part of gross income under the New York law, but are taxed separately. Consequently *capital losses* are deductible only from capital gains. As with capital gains no distinction is made between short-term and long-term capital losses. The only connection between the ordinary income tax return and the capital gain tax return is the right given the taxpayer to offset an excess of the personal exemption over ordinary net income against net capital gains. The Federal law allows the deduction of capital losses computed at 100% or 50% according to the holding period of the capital asset to the extent of capital gains in the case of a corporation and to the extent of capital gains plus $1,000 or the net income of the taxpayer, whichever is smaller, in the case of an individual. Both laws allow the carry-over of a net capital loss for five years, the loss carried over being then deductible under State law from net capital gains, and under Federal law from capital gains in the case of a corporation, and from capital gains plus $1,000 or net income in the case of an individual.

Involuntary Conversions

Both laws do not recognize any gain resulting from an *involuntary conversion,* that is the receipt of money or property destroyed, stolen, seized or condemned, provided however that the money received is used directly or indirectly to acquire similar property. But the Federal law allows a deduction for a loss resulting from an involuntary conversion while the State law does not.

Worthless Bonds

Both laws agree in the treatment of worthless bonds as capital assets and not as bad debts. Non-business bad debts are considered short-term capital losses under the Federal law. The State law does not distinguish them from other bad debts.

Depreciation

The deductions for *depreciation and depletion* are treated similarly under both laws and as to the latter, Art. 190 of the State Regulations expressly adopts the principles and

rules adopted by the Commissioner of Internal Revenue.

Contributions and Medical Expenses

Both laws have set up a limit of 15% for the deduction of *contributions* and a non-deductible minimum of 5% for *medical expenses.* Under State law both percentages are applied to net income before these deductions, the minimum for contributions being first determined before determining non-deductible medical expenses. Under federal law the restrictive percentages are applied to adjusted gross income, that is gross income less trade and business expenses and capital losses.

Alimony Payments

Alimony Payments are deductible by the husband on the Federal return if the amounts are includible in the gross income of the wife. The State law applies this restriction only to non-resident husbands.

Deduction for Life Insurance Premiums

A deduction unknown to the Federal law is that for *life insurance premiums* on the life of the taxpayer to the amount of $150 while the State law does not provide for a special deduction of $500 to blind persons.

Standard Deduction

The State law has not adopted the *Optional Standard Deduction* introduced by the Individual Income Tax Act of 1944.

Credits—Personal Exemption and Dependents

As stated above, important differences exist as to personal *exemptions and credits for dependents.* (a) With respect to the definition of "dependent", the Federal law includes only a close relative who received more than half of his support during the taxable year from the taxpayer and who had less than $500 gross income of his own. Under State law a dependent is a person whether related to the taxpayer or not who receives his chief support from the taxpayer and who is either under eighteen years of age, or incapable of self support, or who if over eighteen years of age attends a recognized school or college full time. The taxpayer is entitled to the dependency credit even if the dependent is a person who establishes for the taxpayer his right to a personal exemption as head of a family. The head of family exemption has been eliminated under the Federal law, nor does the Federal law any longer provide for a marital exemption for husband and wife living together to be divided between them as they wish on their separate returns. The State law still retains these provisions. Under Federal law a single person receives a credit of $500 for the normal tax and $500 for the surtax; married persons receive an additional $500 (with certain limitations) for both taxes and $500 as a surtax exemption for each dependent. Under State law the exemption is $2,500 for married persons and a head of a family; $1,000 for single individuals and $400 for each dependent. Estates and trusts are entitled to an exemption of $1,000 under State law; the credits under Federal law are $500 for estates and $100 for trusts. If the marital status changes during the year, the State law prescribes the apportionment of the exemption; for the Federal law the last day of the year determines the credit. The State law does not allow a credit for the tax paid by the issuing corporation on tax free covenant bonds. In fact an agreement to pay the income tax or assume it is unlawful.

Tax Rates

The principal differences between the two laws is in the tax rates. The Federal normal tax is 3% and the

surtax is graduated from 20% to 91% of net income. The State tax is graduated from 2% to 7% and the capital gain tax from 1% to 3½%; furthermore the State legislature in recent years, including the current year, has permitted a reduction of 25% on both the normal tax and capital gain tax.

Pay As-You-Go Plan

Under the "pay as you go" plan the payment of the individual Federal income tax is withheld currently or paid on an estimated basis. The excess of the final tax due over the amounts withheld or paid as estimated tax, must be paid on the date the return is due. The State income and capital gain tax may be paid in four equal installments.

Withholding Features

Similar to the withholding provisions of the Federal law with respect to periodic payments made to non-resident aliens, the State law requires all individuals, corporations, partnerships and associations making periodical payments to a non-resident or other payments that constitute taxable income to a non-resident, to withhold the amount of tax on the amount paid above the exemptions specified in the law. The law requires every resident employee to file a certificate of residence so as to avoid a withholding and every non-resident employee must file a certificate of non-residence showing the exemptions claimed. The latter provision is one of those more honored in the breach.

Refunds

The time for claiming a refund of State income taxes paid is two years from the time of filing the return or one year from the time of recomputation or assessment by the State Tax Commission. Under Federal law it is three years from the time of filing the return or two years from the date of payment of the tax.

Unincorporated Business Tax

In addition to the normal and capital gain tax every individual, partnership, association or other entity doing business in the State of New York and not subject to the franchise tax must pay an *Unincorporated Business Tax*. Wage earners and members of recognized professions are exempt. The net income is computed in the same way as for the personal income tax except that only those items of gross income and deductions are included that are attributable to business. For this tax capital gains and losses arising from business are not separately treated. A specially computed deduction is allowable in lieu of proprietors' salaries. Instead of January 1, 1919, the date of January 1, 1935 determines the value of property acquired before this date. The problems of this novel tax arise from such questions as: What constitutes a business? Who is a member of a recognized profession? If business is carried on within and without the State, and the books do not disclose the income earned in New York an allocation formula is applied. It should be noted that virtually this allocation formula has now been adopted under the new Franchise Tax Law. The tax is 4% after an exemption of $5,000 or a fraction thereof, if the business was carried on only for a portion of the year. A return must be made, due on the same date as the personal income tax return if the business gross income is more than $10,000 or the net income more than the exemption allowed. The tax is payable on the date of the return.

As has been stated above the Unincorporated Business Tax is considered as an income tax, not a franchise tax and hence is not deductible under the provisions of the State

Income Tax Law permitting a deduction for taxes.

Conclusion

Under the impact of high Federal tax rates the New York State income tax is relatively unimportant for most taxpayers, especially since the New York State tax is deductible in computing Federal net income. However, it would be a desirable improvement to simplify the State tax structure even to the point of abolishing the tax entirely.

Proof of Facts Through Accounting Data—Accountants' Expert Testimony

By William R. Donaldson, C.P.A.

WHILE as Mr. Oehler told you in his introduction, I am a member of the bar, after passing that examination in June 1916, I went to the Graduate School of Business Administration of New York University and, when my war service ended, in March 1919, I entered the field of public accounting and therein I have remained ever since. So tonight, in discussing the topic of the evening, I am presenting it to you as an accountant and will talk from the accountant's viewpoint. In instances where I may be using legal terminology, I'm afraid I can be accused of a slight "accent"; but Mr. Rogge can correct that when he follows me.

I have a few notes here, nothing especially prepared, and I will run through them in relation to the outline of this talk which has been given to you.

The general rule is that books of account and accounting records are admissible proof and, of course, you know from your legal experience that they must be introduced and identified by witnesses competent to establish authenticity; and, as is also generally the rule as I understand it, such records must be further qualified in several respects; that they have been kept correctly in the ordinary course of business and that the entries were made at or reasonably near the time of the transaction.

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Of course they are *prima facie* evidence only, as you realize, and it is possible, under various conditions, to go back of the books and records and establish by other means of proof that they are not altogether correct or even perhaps entirely incorrect. Thus if you have to, you can proceed from another angle to disprove those records.

The task of identifying the books, the accounts and the records is not that of the public accountant (as my function in life is) but rather that of the bookkeeper or of the person in charge of the accounting department; those who are directly in charge of the accounts and who are responsible for determining the principles of and the basis for the entries that are placed in the books and have, necessarily, the day-to-day ordinary course of business contact with them. I can imagine instances where perhaps it becomes necessary to introduce books of a company that has been defunct, and all the persons who have had direct

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contact with them seem to have disappeared. I don't know, I can't say authoritatively if this is true—perhaps Mr. Rogge can touch on that point—but I should imagine the certified public accountant who examined those books years before might be called upon to bring in his working papers and relate his working papers to the books and testify he saw those books at the time—that he observed they were kept in the ordinary course of the business and that, so far as his examination showed they were correct and currently kept. I can see instances where the certified public accountant who audited the books would make an excellent witness, competent and qualified to get that type of evidence into the record.

You have heard through this series of lectures on accounting—at least those of you who attended most of the lectures—a good deal of the mechanics of accounting. The books and records naturally would consist of a mass of material divided into so-called "original records" and into the secondary records. The original records are the source material. We might say they would consist of vendors' invoices, the paid checks returned by the bank, copies of invoices forwarded to customers, shipping sheets or copies of bills-of-lading, the time cards of employees in the shop, requisitions for materials and supplies, copies of purchase orders, duplicate deposit slips, monthly bank statements of the bank, customers' original orders, the production reports in the factory, and that type of data.

From that mass of material is correlated and assembled most of the entries made in the secondary records, and these are the major books themselves which would be the ledger, the journal, the sales record, the purchase record, the cash book or other books into which transactions are summarized and thence posted up into the general ledger and the subsidiary ledgers. These might consist of: customers' ledgers; vendors' or accounts payable ledgers; the cash receipts book; the cash disbursements book; the payroll sheets; records of materials purchased, stored and issued; factory production records and the like; and then, as I said, the general ledger and the journal, the latter being used for summary entries and adjustments.

There may be instances where you are searching for some records and you think you have everything the accounting department can supply yet you have a problem of incomplete proof. If you go a little further sometime you can find it. For example, recently we had a patent accounting case in the printing press field. The question arose of determining the life of a certain type of cylinder used on a particular high-speed press. There wasn't anything in the accounting department records. Someone thought, why not go out in the plant and see the foreman. You will find in almost all factories, the foremen keep a lot of records of their own that do not fit into the scheme of things higher up, that nobody knows about — their own "pet" records. Lo and behold, the foreman pulled out of a bottom drawer a very interesting and helpful record of his own that enabled us to make the proof on the point involved.

So I urge you, if you have a case of that kind, do not be content altogether with what the accounting department may tell you it has, but dig around in the sales department, in the purchasing department, or in the factory and you may find some records there that will be helpful in putting over your point.

While I have been rather sketchy in telling you the type of secondary and original records, in many large corporations there are many other types of records; but they all fit into

the general pattern I have outlined to you.

What can we prove from the books and records? Since all business transactions find reflection in books of account and are expressed in accounting terms indicating the relationship of the transaction as between parties and frequently some details of the nature of the transactions, in the absence of more direct means of proof the books can be referred to for that purpose, or perhaps secondarily for substantiating a position that is presented by another source of proof. But remember that the books and the bookkeepers are not infallible, and many times it is possible to show that the books do not correctly reflect a transaction and the legal relationships arising under the transaction is different from that expressed in the accounts.

Just for example, the books might show goods shipped and charged to a customer as a sale when, as a matter of fact, the goods were shipped "on consignment", the title had not passed and still may remain with the vendor; or the books may show the ownership of machinery and equipment when, in fact, it was a rental transaction with title to pass only when final instalment was paid. You may find securities on the books as owned when, in fact, they were merely borrowed. These are just typical of some instances where the facts differ from those reflected in the accounts.

Now on to another phase of our discussion. How does the accounting expert enter into a case and how can he be helpful? As I said before, he is not the best witness to present or explain a particular transaction recorded in the accounts, that is the job of the one keeping the accounts. But when a great many complicated transactions are involved in the framework of proof and they spread themselves through various books and records, then the testimony of the expert may be offered and is admissible on the basis that he has reviewed the books and records, tabulated and summarized the entries and has reached a bookkeeping or accounting conclusion which may be shown in schedules prepared by him or under his direction.

This step in proof, I understand, has become pretty well established and accepted in all jurisdictions. Mr. Rogge will, perhaps, tell you more about this in his part of tonight's program.

Naturally the witness must be qualified as an expert, and all the rules you know of so well about qualifying the expert apply here: he must have special technical education and training, general experience in accounting and auditing and preferably special experience in the field involved in the dispute.

As to the quality and standing of expert accountants, you have the same problem as with any expert. *Prima facie,* of course, the certified public accountant is the best expert, the possession of the certificate granted to him by the State manifesting, initially, his training and experience and that he has passed an examination and the State has so accepted and certified him. On top of this, of course, he should be further qualified by his familiarity and experience with the particular problem involved, if that is possible.

Proceeding from the type of case where the accountant's expert testimony is presented to explain and summarize complicated accounting facts, we go into a broad field of cases where accounting *principles,* as distinct from facts, is the point at issue. You should know the distinction between a principle and a fact, because when principles are to be established that field is entirely in the realm of the accounting expert. In telling you what a principle is and trying to distinguish it, I am

not going to quote the technical or legal definitions, but intend simply to give you the key to the distinction so you will recognize it when you see it and will know enough to consult an expert for further help and advice.

Let us approach it this way: Basically, we may say, accounting principles are trade practices; conventions that have been regularly adopted and followed so that they come to be recognized as the accepted and proper method or practice of expressing things or relationships in the books and in financial statements. Now, accounting principles and practices are naturally of historical development built up by usage and broad acceptance and following. You can well imagine, with the great expansion that has occurred in the last century in industrialization, factory development and the growth and complexity of corporate organization and functioning, all of which must find reflection in financial statements, that the body of accounting principles and practices has been building up collaterally at a rapid rate and under constant flux and change.

New conditions and new relationships are arising daily requiring accounting treatment and reflection. Ground has to be broken freshly for some of these things, and the accountant has to make many decisions in recording transactions and in expressing them in financial statements for which there is no or little precedent. As the class of condition or relationship expands to include more and more instances of a similar character, there comes a shaking down of the manner of accounting treatment and expression, so that it tends to uniformity of handling, to wider following and grows toward a generally accepted accounting principle or practice.

During these periods of development of new principles there naturally arises varying schools of thought advanced and advocated by accounting experts, well-known certified public accountants, university professors teaching accounting, the chief accounting executives of large corporations, Governmental departments, commissions, agencies, etc., and as in law there is a great deal of writing and discussing in lectures and in current journals dealing with accounting problems, and so the discussion goes on until in time, as I have said, a generally accepted trend becomes manifest. As you know, many disputes involving accounting principles find their way into lawsuits and legal proceedings of various sorts. Then comes, in such a case, the procession of experts for both sides, men of these different schools of thought and of experience and, out of the dispute, comes the decision of a court or other governmental body.

That decision has to decide an issue—what is the correct accounting principles or practice involved in the case. So we find impinged on the body of principles a determination by a Court or a governmental department or agency that this or that is the correct principle. And, as you can well imagine, these decisions sometimes—and many times—go off on wide tangents in this technical field, as they do in a great many other technical fields, and wind up with a conclusion that seems to do violence to what the main body of skilled practitioners considers sound and "the right answer".

The American Institute of Accountants, through its Accounting Research Bulletins, in one of its reports by the Committee on Terminology, discusses the question of what is an accounting principle. I shall read a few paragraphs which are very much to the point. The committee goes to Webster, The Standard, and The New English

Dictionaries and comments on the various definitions of "principle" as follows:

"The first is 'source, origin, or cause', which is of little help to accountants except as it emphasizes the primary character of some principles. The second class of definitions, as given in the New English Dictionary, is, 'A fundamental truth or proposition on which many others depend; a primary truth comprehending or forming the basis of various subordinate truths.' The third is 'A general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice. . .'

"This third definition comes nearest to describing what most accountants, especially practicing accountants, mean by the word 'principle'. Initially, accounting rules are mere postulates derived from experience and reason. Only after they have proved useful, and become generally accepted, do they become principles of accounting. But in discussion the word is often invested with an aura of sanctity, arising out of its more fundamental meanings, thus leading many to attribute to the rules of conduct called 'principles' a greater force and a more universal and permanent validity than most of them were ever intended to have.

"The Investment Company Act of 1940 uses (in Sec. 19) the expression 'good accounting practice'. Objection to this expression has been taken by laymen in the past on the ground that it applies the test of what is rather than of what ought to be, and implies that there is not one best practice, but possibly many that are good. In both respects, however, it is realistic, and since the Congress has used it, the Institute might well do so. The obvious objection to that—the phrase 'generally accepted accounting principles'—is used in the standard form of auditor's report or certificate and confusion would result from attempts to effect a change. At the moment this objection may well be controlling, but if the phrase 'accounting principles' is to be retained, every effort should be made to establish clearly the extent and the limits of the significance of the phrase.

"In so far, therefore, as 'principle' continues to be a necessary word to accounting discussion, care should constantly be taken to make it clear that, as applied to accounting rules of practice, it does not connote a law of that high order from which there is no appeal. An accounting principle is not a principle in the sense that it admits of no variation, nor in the sense that it cannot conflict with other principles. The analogy to principles of law suggests itself; they frequently conflict with each other, and in many cases the question is which of several partially relevant principles has determining applicability. This situation is so familiar in law that it is surprising to find it giving rise to any question in accounting."

As typical of an area in which principles are being currently evolved let us consider for a moment the immediate field of war activity with such things as cost-plus-fixed-fee contracts, renegotiation, terminations, amortization of war facilities, V loans and VT loans, Defense Plant Corporation rentals, wage and salary stabilization, limitation orders, price ceilings, allotments, etc. All kinds of transactions are being carried on under this structure of wartime laws and regulations and must be entered daily in the books and reflected in financial statements. How shall these be recorded and expressed to stockholders, to bondholders, to credit grantors, to executives employed under profit-sharing contracts? How is income measured, particu-

larly on a year-to-year basis during the war period? New ground is being broken today on the accounting treatment of such things, and a body of principles and practices is being built up with many varying conceptions of what the right treatment should be.

Six or seven years ago the leaders in the accounting world, realizing the great need for some authoritative or semi-authoritative pronouncements of what might be considered generally accepted accounting principles with respect to some of the newer problems particularly, organized and launched, within the American Institute of Accountants, a well-staffed and competent Research Department. From the work of this Research Department has flowed, through the Institute's Committee on Accounting Procedure, a series of Bulletins dealing with important or pressing moot situations, and these are continuing to come out, a half a dozen or so each year.

This Committee is a large Committee composed of the top men in the accounting profession, and even here we find, when we read these Bulletins, some very strong dissents, just as we discover in the decisions of our own U. S. Supreme Court. While these Bulletins have not the authority of, say, a high court decision, they do reflect *prima facie,* at least, the official thought of the profession and, if a point covered by one of the Bulletins is involved in any case you are in, you would start off a bit "behind the eight ball" in your efforts to combat the effect of any such pronouncements. Of course these Bulletins touch only a few in the vast body of principles and practices built up through the years and there is a wide area in which expert testimony, if required, would not have the support, or, to the contrary, the disadvantage of these particular Bulletins.

For the balance of our time I should like to deal with a few of the kinds of disputed or litigated situations in which expert testimony as to accounting principles and practices might be involved. We will go over them quickly and high-light what might become issues in cases of this sort.

Take partnership dissolution and accounting as the first one: Determination of the retiring partner's or his estate's share will have to be calculated. If you have a well-drawn partnership agreement before you, you can probably "spell out" sufficiently well the fair and correct settlement; but that isn't often the case. You must sit down and figure out what is sound accounting treatment for determining the worth of the business as well as the earnings accrued and payable to the retiring partner or to the estate up to the date he retired from the firm or died.

You will frequently find this problem: in many small partnerships, they have their own pet way of keeping their books and stating their earnings. Many times they are far away from a basis regarded as generally accepted accounting principles, so you will find the executor of an estate—a trust company, for example—after taking a look at what the accounts show, finding plenty of reasons for objecting and attacking the whole structure of the accounts in order to determine the worth of the business as well as the earnings that have accrued for the period up to the date of death.

Then there is another field in which there have been many disputes, that is incentive compensation to corporate officers based on percentage of profits. Many of such agreements are general or informal in language with the result that several accounting principles relating to the measurement of earned

income or profit might be involved. More particularly this is one of the most difficult areas in accounting expression, as you have probably heard at these lectures: measuring income earned year by year.—What is deferred income?—What should be carried over to next year?—What should be deferred expense carried over to future years? And, on a profit-sharing contract, there may be many disputes arising from whether certain specific items are includible as income or as expense within the current bonus year.

Another class of cases. We find, more or less recently, perhaps mostly in the retail business, that real estate rentals are based partly on the profits of the store. Here will come problems of determining what is properly a capital charge. —What is proper depreciation?—The treatment of certain prepaid expenses, may be involved.

Another field in which accounting questions may arise is the matter of breach of covenants in bond indentures. You know the form of indenture under which most industrial mortgages or debentures are issued. There are provisions requiring the maintenance of certain ratios of current assets to current liabilities and specified amounts are required to be retained for working capital: no dividends may be paid if the working capital shall be reduced below a certain figure or the ratio of current assets to current liabilities shall be reduced lower than two-to-one, etc. Some indentures permit additional series of bonds if the amount of earnings for a period of years is so many times the interest to be paid on the outstanding bonds as well as the additional bonds to be outstanding.

In cases of this sort where the ratios get close to the line many accounting principles are applicable in determining whether a certain account shall be included or excluded from current assets or current liabilities. Let us take a business that sells its products on the installment basis, say, over eighteen months. The general rule is that a current asset is one which in the normal course of business will be collected or realized on in twelve months. Here we find one-third of the billings to customers apparently will not be collected within that period. Is such proportion includible as a current asset under the terms of the indenture?

You will find in certain industries there has come to be accepted practices of classifications in respect of various exceptional items. When a bond indenture is being drafted to include accounting and financial requirements you lawyers should certainly call in the C.P.A. auditing the company's books and he will help you write these provisions and their accompanying definitions. He will recognize, for example, in the case mentioned that receivables do run up to eighteen months and whether to include or exclude the portion due beyond a year as a current asset must be decided on and covered in the definitions.

Some indentures rather specifically designate what is a current asset and what is current liability; but many simply say that they shall be determined "in accordance with sound accounting practice", or some such phrasing; and here may arise disputes of the nature we have been talking about tonight.

Another type of case where differences may appear—income debentures. Quite a few of such issues are outstanding on reorganized real estate properties where mortgages went into default. Agreements provide for paying interest if earned and the balance of earnings to go into sinking fund or sinking fund reserve, with provisions for reserving for unpaid liabilities, etc. It is very difficult, sometimes, to calcu-

late the amount available for interest, and available for sinking fund, because the lawyers who drew the provisions knew little about accounting and accounting terminology with the result that it is a Chinese puzzle to follow through the intention.

In mortgage issues we also find accounting principles involved in determining sinking fund payments based on a percentage of profits.

Section 58 of the Stock Corporation Law, that is the liability of directors for paying dividends out of capital, is the basis for suits in which accounting principles may be the main issue. Most states have similar statutory provisions. In New York, however, the Bush Terminal case holds that the determination of the value of the assets is not an accounting determination but an appraisal determination, so that where assets have gone up in value they should be increased to market value and, per contra, lowered in value if the market value has declined. The accounting conception of book value of assets seems out in this type of case—at least in this state. Though it would seem the accounting conception still applies on the liability side.

One of the most complex fields of legal accounting is that of patent damages. The procedure for determining the net profit yielded by the infringing device, especially when it is only a part thereof or accessory to a non-infringing device, is a tedious and difficult task. The problem involves not only measuring costs and expenses attributable to or apportionable to the device, but also calculating what portion of the income or sales price flows from the patented features. Voluminous schedules and long hearings before a special master usually is the result, with much expert testimony on the properly applicable accounting principles and practices.

Mail fraud cases and those involving credit obtained on false financial statements usually call for the aid of the accounting expert. Not only may accounting facts be in issue but also the accounting principles employed in assembling, classifying, and presenting financial position, and too whether adequate disclosure of material facts has been made.

Occasionally are found cases against public accountants alleging loss to third parties resulting from reliance on statements certified by the accountants which proved to be erroneous, either through fraud or negligence. Unless the instance is a flagrant or obvious one, the issue may turn into a battle-royal of experts, especially where the scope and adequacy of the accountant's examination becomes a prime issue in the claim of negligence.

Outside of the litigated situations you lawyers may frequently find yourselves involved in proceedings and hearings before Governmental bodies and agencies where you need the help of accounting experts—and may have to call on them to testify. The valuation of closely held corporations for the purpose of determining estate taxes and gift taxes is one sort of situation, for in these cases the securities have no free market and quotations are not available. Accounting analysis of financial worth, of earnings and earning power and of intangible factors is required in order to work out a proper and fair formula for valuing the securities. As I stated in discussing partnership dissolution you find frequently that in closely held corporations pet and unorthodox principles of accounting may be followed in keeping the accounts. In such case the accounting expert may find it well worth while to recast the accounts and statements in order to furnish a

proper and sound basis for the valuations to be made.

In income tax cases you may be handling for clients you will find most times you should have the assistance of the C.P.A. because accounting principles and practices applied in light of the specific statutory provisions constitute the nub of most cases.

Utility rate making and regulation is another field in which the use of accounting testimony is ordinarily needed. Some fundamental and important accounting principles are presently the main issues in proceedings under way in several states. These issues involve proper depreciation charges and the treatment in the income statement of expenditures for intangibles.

"Stop-order" hearings before the S.E.C. frequently go to the issue of the correctness and adequacy of disclosures made in financial statements. Again the use of the accounting expert is required.

Federal Trade Commission proceedings under the Robinson Patman Act are full of accounting questions—the justification of price differentials by the variations in costs in the various levels and avenues of distributions. Accounting principles and practices in the allocation and apportionment of costs must be established by expert testimony.

During our wartime days with its control of prices we find the use of the expert accountant frequently necessary in applications to the O.P.A. for price increases and also for setting approved prices for new products.

Should you be serving your clients in renegotiation proceedings or assisting in settling terminated war contracts or sub-contracts you have found that you need the C.P.A. at your elbow to guide you through the mazes of schedules and calculations, all involving the application of accounting principles and practices.

I could recite many other kinds of situations where the lawyer is called on for counsel and help in which accounting considerations are paramount but I have used up my alloted time. I hope this talk has given you the key to recognizing where and how you can look to the C.P.A.—the accounting expert—to cooperate with you to serve the best interests of your clients.

What Did He Do When He Got There?

By Lt. Comdr. Lewis Gluick

ONE day recently a man next to me in the bus said "well, I see you've been around; glad of it. Too d—— many of these men strutting around in uniform who've never been near a fight. They make me mad".

To the best of my ability, in the few minutes that were left before my stop, I tried to tell him how wrong he was. But the subect has been a sore one with me for so long, that I want more people to know more about it. I can talk subjectively, because, in two wars, I've been around. But as millions of our men come back home it's going to be absolutely necessary for this matter to be understood thoroughly, so that there may be peace in the family, and friends remain friends. So get this: *Not one man in ten thousand ever has a chance to do anything about where he's going to go.* So why praise the man who got overseas, and look down upon the man who didn't? I admit there are politicians and skulkers, but because there are a tiny number of them, is it right to cast aspersions on the honest men? I know that many of the ribbons being worn can not be backed up by service records, but the offenders are practically invited to cheat by the attitude of too many people. A man goes where Uncle Sam sends him. The only thing that counts is: *What did he do when he got there?* If he did the best he could in his appointed work, it isn't his fault if he didn't get shot. Let's get down to cases, if that idea doesn't click of itself.

During the old war, in my home town (village) one young man had to be brought into the draft board by the sheriff. He was thoroughly scared of the war. The army took him, and eventually his outfit got into some hot spots. He came through all right and to some extent the army had made a man out of him. But on his return home, he was not content to let matters rest. It's a good thing for a man to boast of his outfit, and not too bad to do a bit of personal bragging. But when he took to making condecending remarks to some men who had enlisted, but not gotten overseas, and then even became insulting, it was necessary for some Legionaires to remind him of how he got into the Army in the first place.

Then there was the man who enlisted at the age of 33, although in the war of 1917-18 the upper age limit was 31, he won quick promotion to top-kick. Three times he whipped a Company into shape, three times he was detached from it as it left for France, because the higher up officers wanted that man to train new companies. He did a magnificent job and was a good enough soldier to take what came, though his heart was always with the first company he'd trained. But you couldn't sell that to the folks at home. The draftee that fought the "battle" of Paris was the hero; the man who stayed in a stateside cantonment was just a step ahead of a slacker.

And this condition is prevalent today, and unless something is done about it soon, it's going to be worse. Won't all of you please treat all returned service men on the sole basis

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of whether or not they have been honorably discharged. One more case on this point. In the ship on which I served most recently we had as boss baker a man who, when his 17 year old son shipped, would not be outdone and gave up his job as foreman of a huge bakery to go too. You and you and you may not think that being a baker is a very romantic job, or that a baker is a fighter. But the ship made a fine record, and the skipper told the old baker, "No man on this ship has done more for the morale than you."

Never mind what a man's rank or rate was. *What did he do while he had it?* That's all that counts.

Changing the subject, I'd like to say a few words about the bunk that is being broadcast about our service hospitals, or rather the men in them. There are tens of thousands of men who have wounds, and diseases worse than wounds, service incurred and it's a fine thing to make over them. They earned it. But every man in an Army or Navy hospital is not a hero. Even leaving aside the few who are there as "the result of their own misconduct", there are thousands who are just sick, in the same manner as a civilian might be. Take a case I know well, because it is my own, as a concrete example. I had a sore back, the doctor said, "Now if you were only home, I'd just tell you to stay abed awhile, and let your wife put hot packs on your back. But as it is, you'll have to go to the hospital." So I spent five days in a magnificent Navy Hospital, with skilled hospital corpsman doing what my wife could have done had I been home, and left cured. There were plenty of cases no worse than mine. But to hear the visiting "stars of stage and screen" tell about it, every man there was a wounded hero. Let's be sensible about it.